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C O N F I D E N T I A L SECTION 01 OF 02 RIGA 000484

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TAGS: ECON EFIN BTIO PGOV PREL EU LG
SUBJECT: LATVIA: POLITICAL INFIGHTING THREATENING PASSAGE
OF A CREDIBLE 2010 BUDGET

REF: RIGA 00401

Classified By: Charge d'Affaires, Bruce Rogers, for reasons 1.4 (b) and (d).

¶1. (SBU) Summary: Political infighting among members of the governing coalition is threatening the passage of a credible 2010 budget. If Latvia does not pass a credible budget, the consequences could include not only the end of international assistance and a weakening of investor confidence, but possibly devaluation of the currency and further short-term economic deterioration. End Summary.

¶2. (SBU) On September 20, Prime Minister Valdis Dombrovskis announced that the Cabinet had agreed on the outline of a 2010 budget that calls for LVL 324 million (USD 650 million)in fiscal deficit reduction, effectively acknowledging that the government will not comply with its IMF and EU commitments to reduce the 2010 budget by LVL 500 million (USD 1 billion). Dombrovskis told the press on September 23 that any attempt to reduce the budget further would result in a political "dead end." The government's decision follows weeks of very public infighting within the governing coalition, most notably the People's party's new stance against any additional tax increases, which has even generated talk of the possible collapse of the coalition.

¶3. (C) The People's party, which is the largest coalition party, lacks any political incentive to cooperate on the budget given its 1.8 percent public approval rating and the widespread unpopularity of budget cuts. But the People's party is not alone in jockeying for advantage in advance of next year's Saeima (parliament) elections. In a demonstration of the lack of cohesion within the governing coalition and the lack of consensus on how to effectively reduce the budget deficit, Saeima defeated an already watered-down real estate tax measure on September 18. Two of the largest coalition parties (People's party and Union of Farmers and Greens) voted against the measure, which was explicitly included in the country's Letter of Intent (LOI) with the IMF. When asked about the ramifications of the measure's defeat, the Chairman of Saeima's budget committee said, "I think you can draw your own conclusions." Saeima member Artis Pabriks of the Society for Alternative Politics conceded that there's little prospect for passing a budget that includes LVL 500 million in deficit reduction, and said, "We need a new way forward." As with other politicians, Pabriks is well aware that public unhappiness is at an all time high, with 82 percent of Latvians believing the government is headed in the wrong direction while 89 percent currently distrust the government.

¶4. (C) Gints Feimanis, the Economic Advisor to the PM, stated that no final budget decisions have been reached, noting that Saeima must still agree on and pass the budget. He conceded, however, that the government's recently announced deficit

reduction measures were as much about political feasibility as they were about meeting its obligations, which he said are "open to some interpretation." Freimanis concluded, "We can collapse with or without the IMF," and added, "We're aware of the consequences."

¶5. (SBU) The government will likely claim that it's reduced cuts still meet the criteria of the LOI and the EC's MOU based on two arguments. First, Freimanis and the Deputy State Secretary of the Ministry of Finance, David Taurinsh, have independently told us that the government believes the difference between its LVL 500 million commitment and the LVL 324 million figure announced will be made up by carry-over from 2009 deficit reduction measures. Second, the government believes it will still make the deficit target of 8.5 percent of GDP in 2010 without more severe expenditure cuts or tax increases. This belief is predicated on a more optimistic economic outlook than the IMF's.

¶6. (C) On the first point, David Moore, the local IMF Resident Representative, said that carry-over is explicitly out-of-bounds and that the LOI is clear that it must be 500 million in "new measures." Moore also noted that the IMF previously informed the government that carry-over savings should not be included in the definition of "new measures" back in early August. Following the IMF's clarification, the MOF and the PM's office had been clear in public statements and in private meetings with USG officials that they would pursue a budget with LVL 410 million (USD 820 million) in cuts and LVL 90 million (USD 180 million) in tax increases. On the second point, Moore said that the IMF budget team that arrived on September 28 would "kick the tires" on the

government's numbers, refusing to say explicitly that the current plan would fail to meet its requirements.

¶7. (C) Moore also speculated that Dombrovskis' statements and the government's budget outline may reflect either a common understanding or, possibly, a deal with the EC, given that the government's decision followed closely on the heels of a private meeting between Dombrovskis and Economic and Monetary Affairs Commissioner Joaquin Almunia. Newspaper editorials, including one by a member of Saeima, have fueled the speculation that Latvia might try to proceed only with the support of the EU and not the IMF, despite the fact that there appears to have been no public discussion of the economic ramifications of an IMF-EU split. Nonetheless, Almunia stated clearly that Latvia should abide by its commitments to international lenders in a statement released immediately following his meeting with Dombrovskis. In addition, the Deputy Head of Mission of the British Embassy, Daniel Grzenda, and the Head of the French Economic Mission in Latvia, Jean-Francois Dathie, told us that such speculation is "completely unrealistic", and pointed to the recent efforts of the EC to coordinate its program reviews with the IMF.

¶8. (SBU) Comment: The consequences of a Latvian failure to meet its IMF commitments are difficult to predict, but would certainly include an erosion of investor confidence and further contraction of the economy as Latvia's already limited access to credit is squeezed. Politicians are publicly calling for economic stimulus measures, but seem unable to grasp the reality that without international financial assistance there will be limited money with which to stimulate. Failure to pass a credible 2010 budget won't obviate the need for further budget reductions, it will merely require them in the absence of international loans and investor confidence. Among the most disruptive potential consequences is the devaluation of the Lat, which could result if investor confidence is shaken sufficiently to incur a run on the banks or a massive withdrawal of foreign exchange. In fact, for the first time in months the Bank of Latvia intervened in the foreign exchange market on September ¶28. While viewed in some corners as necessary or even

inevitable, a devaluation of the Lat might also put pressure on the currencies of neighboring countries, thereby diluting the competitive benefit any devaluation might have. End comment.
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